IFRS® Discussion Group

Report on the Public Meeting

September 25, 2019

The IFRS Discussion Group's purpose is to act in an advisory capacity to assist the Accounting Standards Board (AcSB) in supporting the application in Canada of IFRS® Standards. The Group maintains a public forum at which issues arising from the current application, or future application, of issued IFRS Standards are discussed and makes suggestions to the AcSB to refer particular issues to the International Accounting Standards Board (IASB) or IFRS Interpretations Committee. In addition, the Group provides advice to the AcSB on potential changes to IFRS Standards and such discussions are generally held in private.

The Group comprises members with various backgrounds who participate as individuals in the discussion. Any views expressed in the public meeting do not necessarily represent the views of the organization to which a member belongs or the views of the AcSB.

The discussions of the Group do not constitute official pronouncements or authoritative guidance. This document has been prepared by the staff of the AcSB and is based on discussions during the Group's meeting. For a full understanding of the discussions and views expressed at the public meeting, listen to the audio clips.

Comments made in relation to the application of IFRS Standards do not purport to be conclusions about acceptable or unacceptable application of IFRS Standards. Only the IASB or the IFRS Interpretations Committee can make such a determination.

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ITEMS PRESENTED AND DISCUSSED AT THE SEPTEMBER MEETING

IFRS 16: Sale-leaseback Transaction with Variable Payments

IFRS 16 *Leases* provides guidance on accounting for sale and leaseback transactions. If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 *Revenue for Contracts with Customers* and the transaction is to be accounted for as a sale of the asset, paragraph 100(a) of IFRS 16 states:

> "the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor."

Illustrative Example 24 of IFRS 16 sets out an approach to calculate the right-of-use asset [i.e., (discounted fixed lease payments ÷ fair value of the asset) × carrying value of the asset].

Fact Pattern

- Entity A enters into a transaction with Entity B to sell a building and lease it back for a period of three years. The consideration for the sale is $1.5 million. The fair value of the building is also $1.5 million. Assume that the requirements of IFRS 15 are met and the transfer of the building is appropriately accounted for as a sale.
- The lease payments for the leaseback portion of the arrangement include:
  - fixed lease payments for which the present value is $0.25 million (discounted using the seller-lessee's incremental borrowing rate); and
  - variable lease payments that are not dependent on an index or rate, for which the present value of the forecasted payments is $0.25 million (discounted using the seller-lessee's incremental borrowing rate).
- The lease payments reflect the market price for leases of similar assets under similar terms.

- The carrying amount of the building immediately before the sale and leaseback transaction is $1.0 million. The building has a remaining useful life of nine years.

Issue 1: How should Entity A calculate the proportion of the building's previous carrying amount retained in the sale and leaseback transaction?

View 1A – Entity A should apply the approach set out in Illustrative Example 24 of IFRS 16 to calculate the proportion of the building's previous carrying amount retained in the sale and leaseback transaction.

Proponents of this view think that the approach set out in Illustrative Example 24 of IFRS 16 is the only appropriate method to calculate the right-of-use asset in a sale and leaseback transaction.

In addition, paragraph 24 of IFRS 16 provides guidance for measuring the cost of right-of-use assets, which starts with the amount of the initial measurement of the lease liability as described in paragraph 26 of IFRS 16. The measurement of the lease liability excludes variable lease payments that do not depend on an index or a rate. As a result, proponents of this view think that only the fixed payments should be considered in measuring the right-of-use asset, and that the approach set out in Illustrative Example 24 of IFRS 16 should be applied.

Under this view, the right-of-use asset in this sale and leaseback transaction would be $0.17 million [i.e., (discounted fixed lease payments of $0.25 million ÷ fair value of the asset of $1.5 million) × asset's carrying value of $1.0 million].

View 1B – Entity A is required to apply a different approach for the calculation, if it more appropriately reflects the proportion of the building's previous carrying amount retained in the transaction and the rights transferred.

Paragraph BC266 in the Basis for Conclusions on IFRS 16 states:

> "The IASB decided that the gain or loss recognised by a seller-lessee on a completed sale in a sale and leaseback transaction should reflect the amount that relates to the rights transferred to the buyer-lessor. In reaching this decision, the IASB considered requiring the sale element of the transaction (ie the sale of the underlying asset) to be accounted for applying IFRS 15 because, from a legal standpoint, the seller-lessee will often have sold the entire underlying asset to the buyer-lessor. However, from an economic standpoint, the seller-lessee has sold only **its interest in the value of the underlying asset** at the end of the leaseback — it has retained its right to use the asset for the duration of the leaseback. The seller-lessee had already obtained that right to use the asset at the time that it purchased the asset — the right of use is an embedded part of the rights that an entity obtains when it purchases, for example, an item of property, plant and equipment. Accordingly, in the IASB's view, recognising the gain that relates to the rights transferred to the buyer-lessor appropriately reflects the economics of the transaction." (emphasis added)

Proponents of this view think that the above paragraph suggests the calculation of the right-of-use asset arising from a sale and leaseback transaction should reflect the value of the underlying asset retained. The approach set out in Illustrative Example 24 of IFRS 16 may reflect the value retained when there are only fixed lease payments in the arrangement. However, such approach may not reflect the value retained when the arrangement includes variable lease payments as well.

In addition, prior to the transaction, Entity A had the right to use the underlying asset for the full duration of its useful life. Therefore, proponents of this view observe that the proportion of the lease term to the underlying asset's useful life may better reflect the rights Entity A retained. For example, the right-of-use asset in this transaction could be calculated as $0.33 million [i.e., (lease term of 3 years ÷ remaining useful life of 9 years) × asset's carrying value of $1.0 million].

Proponents of this view acknowledge that there could be other approaches as well. Therefore, an entity will need to apply judgment to determine an approach that best reflects the value of the asset retained by the seller-lessee and transferred to the buyer-lessor in the transaction.

View 1C – Accounting policy choice.

Proponents of this view note that since IFRS 16 does not prescribe an approach to calculate the right-of-use asset in a sale and leaseback transaction, Views 1A or 1B may be appropriate.

The Group's Discussion

Group members supported View 1B and thought that Entity A is required to apply a different approach compared to the one set out in Illustrative Example 24 of IFRS 16 for this fact pattern. They noted that paragraph 100(a) of IFRS 16 is a principle and that Illustrative Example 24 shows the application of the principle, and not necessarily a defined approach. Another comment was made that Illustrative Example 24 considers a fact pattern that has no variable lease payments. This example does not imply that when a situation involves variable lease payments, those payments should not be taken into consideration because such payments are related to the portion of the asset retained.

While Group members supported View 1B, a few Group members pointed out that the lease term approach described under this view is difficult to support because they thought that the principle in paragraph 100(a) of IFRS 16 is based on a relative fair value approach. Therefore, calculating the right-of-use asset using the proportion of the lease term to the underlying asset's useful life would not seem to be in line with that approach.

Overall, Group members emphasized that entities need to apply judgment, taking into consideration the specific facts and circumstances of the transaction, to determine which approach to apply to appropriately calculate the proportion of the building's previous carrying amount retained in the sale and leaseback transaction.

Issue 2: Assuming View 1B applies, how should the liability related to the fixed and variable lease payments be measured and presented in the financial statements?

View 2A – Both the fixed and variable lease payments should be presented as a lease liability.

Under this view, because the fixed and variable payments arise from the lease contract, they should be presented as a lease liability so that it is easier for financial statement users to understand. Paragraph B52 of IFRS 16 provides disclosure guidance in this area, including disclosing the key terms and conditions of individual sale and leaseback transactions.

View 2B – Only the fixed lease payments should be presented as a lease liability and accounted for under IFRS 16. Variable lease payments should be treated as a financial liability under IFRS 9 Financial Instruments *and measured in accordance with that standard.*

Based on the guidance in paragraph 27 of IFRS 16, variable lease payments that do not depend on an index are not included in the measurement the lease liability. As such, it would be inappropriate to present such variable lease payments as a lease liability.

Proponents of this view consider that the cash received from the sale of the building is a form of secured financing. As a result, the variable lease payments in the fact pattern should be measured as a financial liability in accordance with IFRS 9.

View 2C – Only the fixed lease payments should be presented as a lease liability and accounted for under IFRS 16. Variable lease payments should be treated as an "other liability."

As it relates to the variable lease payments, proponents of this view think that the seller-lessee has received financing in the form of a cash payment from the sale of the building. However, since there are executory elements in the arrangement between the seller-lessee and the buyer-lessor, a financial liability under IFRS 9 should not be recognized. Instead an "other liability" should be recognized.

In recognizing this "other liability," proponents of this view analogize to the contract liability recognition principles in IFRS 15 or the recognition principles in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The Group's Discussion

Group members expressed mixed views on this issue.

Some Group members thought that both the fixed and variable lease payments should be presented as a lease liability to provide more meaningful information to users (View 2A). These Group members thought that the liability arises from the sale and leaseback transaction, and, therefore, presenting two liabilities could make it challenging for users to assess the full effect of the transaction on the entity. One Group member noted that the outcome of View 2A makes it easier to compare leases across different entities with varying lease payment structures. Another Group member thought a slight variation to View 2A could be to disclose the composition of the lease liability so that

entities disclose the portion arising from the fixed lease payments and the portion arising from the variable lease payments.

Other Group members disagreed with View 2A because IFRS 16 indicates that only variable lease payments that depend on an index or a rate are included in the measurement of the lease liability. Since the variable lease payments in the fact pattern do not meet that criterion, these Group members considered the merits of Views 2B and 2C. A few Group members were undecided between these two views in considering how to account for the liability. However, some Group members, while disagreeing with View 2A, were unclear with the rationale in View 2B on how the variable lease payments are considered a form of secured financing because the building qualified for derecognition. They also questioned the appropriateness of View 2C because IAS 37 scopes out leases under IFRS 16. Therefore, these Group members thought that to determine whether a liability exists, an entity would need to refer to the *Conceptual Framework for Financial Reporting* for guidance.

Some Group members contemplated whether the present value of the variable lease payments is a deferred gain because it is not appropriate to recognize the entire gain when the entity has ongoing variable lease payments. These Group members thought that the deferred gain would be released over time into profit or loss as the payments are made or on another reasonable systematic basis. One Group member thought the variable lease payments are an outstanding performance obligation from the sale of the building, and therefore, IFRS 15 may apply.

Group members observed a growing trend in which leases are structured to include variable lease payments, and these payments could be material to the total lease payments. They observed that these types of leases are prominent in the real estate industry and, therefore, it is important to clarify the accounting for Issue 2. As a result, Group members recommended that Issue 2 be discussed with the AcSB to determine whether it should be raised to the IASB or the IFRS Interpretations Committee.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

IFRS 16 and IAS 7: Cash Flow Presentation of Sale-leaseback Transactions

The Group discussed how the proceeds in a sale and leaseback transaction should be presented in the statement of cash flows.

Fact Pattern

- The following fact pattern is extracted from Illustrative Example 24 of IFRS 16 *Leases*. An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU2,000,000. Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of CU120,000 payable at the end of each year.
- The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15 *Revenue from Contracts with Customers*. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback. This example ignores any initial direct costs.

- The fair value of the building at the date of sale is CU1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. The amount of the excess sale price of CU200,000 (CU2,000,000 – CU1,800,000) is recognized as additional financing provided by Buyer-lessor to Seller-lessee.
- The interest rate implicit in the lease is 4.5 per cent per annum, which is readily determinable by Seller-lessee.

Issue: Given that the sale of the building satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset, how should the sale proceeds of CU2,000,000 be presented in the statement of cash flows?

View A – The entire sale proceeds should be presented as cash flows from investing activities.

Under this view, when an entity enters into a sale and leaseback transaction that satisfies the requirements of IFRS 15, the entity has transferred control of the underlying asset to the lessor and disposed of its interest in the property for cash consideration. Therefore, the sale proceeds should be presented under investing activities in the statement of cash flows in accordance with paragraph 16(b) of IAS 7 *Statement of Cash Flows*.

View B – The entire sale proceeds should be presented as cash flows from financing activities

Under this view, the sale and leaseback transaction is considered a financing arrangement because the sale proceeds are viewed as proceeds from a short-term or long-term borrowing. Therefore, the sale proceeds should be presented under financing activities in the statement of cash flows in accordance with paragraph 17(c) of IAS 7.

View C – A portion of the sale proceeds of CU2,000,000 should be presented as cash flows from investing activities and the remaining portion should be presented as financing activities based on the underlying rights that are retained and transferred.

Under this view, a portion of the sale proceeds pertain to an investing activity (i.e., the disposal of an asset), and a portion of the proceeds pertain to a financing activity (i.e., the lease liability). Since there are two activities, the sale proceeds received from the sale and leaseback transaction should be allocated accordingly.

Proponents of this view analogize to the approach described in paragraph 100(a) and Illustrative Example 24 of IFRS 16 to allocate the sales proceeds between financing activities and investing activities. The portion of the gain on the rights transferred to the buyer-lessor is CU240,355 of the total CU800,000 gain on the sale of the building.

Under this view, the amount classified as investing activities would be CU600,888. The CU600,888 is calculated as the proportion of the gain that relates to the rights transferred to the buyer-lessor multiplied by the sale proceeds of CU2,000,000. The remainder of the CU2,000,000 sale proceeds allocated to financing activity would be CU1,399,112.

View D – Same as View C, except that the sale proceeds to be allocated between investing and financing activities are CU1,800,000 instead of CU2,000,000.

Proponents of this view note that the consideration for the sale of the building is not at fair value so adjustments are made to measure the sale proceeds at fair value. Therefore, the excess sale price of CU200,000 (CU2,000,000 – CU1,800,000) is considered additional financing and should be presented as cash flows from financing activities.

Under this view, the amount classified as investing activities would be CU540,799. The CU540,799 is calculated as the proportion of the gain that relates to the rights transferred to the buyer-lessor multiplied by the adjusted sale proceeds of CU1,800,000. The remainder of the CU1,800,000 sale proceeds allocated to financing activity would be CU1,259,201. The excess sale price of CU200,000 would also be classified as financing activities.

The Group's Discussion

Almost all Group members thought that the excess sale price of CU200,000 is additional financing and should be presented as cash flows from financing activities. Group members then considered how to present the remaining CU1,800,000 sale proceeds in the statement of cash flows.

Some Group members approached the issue from a practical perspective. They thought that requiring entities to pro-rate the sale proceeds between investing and financing activities complicates the statement of cash flows and makes it more difficult for users to see the impact of the transaction. A few Group members noted that for cash flow statement presentation purposes, the entity's business objective should be considered to reflect the substance of the transaction. For example, if the entity's objective is to raise financing, then the cash flows should be presented as a financing activity. However, if the entity's objective is to sell its asset to realize investment gains, then the cash flows should be presented as an investing activity. These Group members viewed that the purpose of presenting the sale proceeds in the statement of cash flows as different compared to calculating the gain on the sale and leaseback transaction because the gain is intended to reflect the rights transferred to the buyer-lessor.

Other Group members supported allocating the sale proceeds between investing and financing activities (View D). One Group member thought that IFRS 16 contemplates a sale and leaseback transaction as two activities (i.e., the entity first sells its asset and then it leases back the asset). Considering this approach, the cash flows should also reflect the two activities. Several Group members also noted that it should not be complicated to split the proceeds between investing and financing activities for cash flow purposes as a similar pro-rata calculation is already used to determine the gain on the sale and leaseback transaction. One Group member noted that for some industries, the statement of cash flows contains key metrics, so it is important that the cash flows from the sale and leaseback transaction are appropriately classified. A representative from the Canadian Securities Administrators also expressed preference for View D and emphasized the need to provide good disclosures to users about the transaction.

A few Group members thought there was merit to either allocating the CU1,800,000 sale proceeds to investing activities, or allocating a portion to investing and financing activities in accordance with View D. Since the transaction satisfies the requirements in IFRS 15 and qualifies as a sale,

classifying the sale proceeds as investing activities seems reasonable. A Group member also noted that there are examples of cash flow items in which an entity has flexibility on whether to classify as operating, investing or financing activities (e.g., interest and dividends). That said, an entity is required to classify such cash flow items in a consistent manner from period to period.

Overall, Group members noted that an entity needs to apply judgment, taking into consideration its specific facts and circumstances, on how to best present the sale proceeds from a sale and leaseback transaction in the statement of cash flows. Group members thought that entities should consider paragraphs 10-12 of IAS 7 and present cash flows in a manner that is most appropriate to its business to allow users to assess the impact of the sale and leaseback transaction. Therefore, no further action on this issue was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

IFRS 16 and IAS 37: Variable Lease Payments and Onerous Lease Provisions

The Group is asked to consider the accounting under IFRS 16 *Leases* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for onerous contract provisions when variable payments are not recognized in lease liabilities.

Fact Pattern

- Retailer A entered into a five-year lease contract to lease a store in a shopping centre. The lease has a fixed base rent per year. In addition to the base rent, Retailer A is also responsible for its proportionate share of the shopping centre's annual realty taxes and common area maintenance costs, both of which are variable.
- Retailer A applies IFRS 16 to account for this lease contract and recognized of a lease liability and a right-of-use (ROU) asset at the commencement date. It also elected, under paragraph 15 of IFRS 16, to account for each lease component and non-lease components as a single lease component. Furthermore, the annual realty taxes and common area maintenance costs are not recognized in the lease liability because they are variable and do not depend on an index or a rate.
- At the end of year 2, Retailer A vacated the property. For simplicity, assume that there is no lease buy-out alternative and no sub-lease opportunities for the remainder of the lease term. There are also no associated leasehold improvements. The ROU asset is no longer part of a larger cash-generating unit and is tested separately for impairment under IAS 36 *Impairment of Assets*. Retailer A has appropriately impaired its ROU asset to nil.
- Retailer A anticipates that it will pay a realty fee of approximately $2,000 and a common area maintenance fee of approximately $5,000 every year for the next three years.

Issue: Should Retailer A recognize an onerous provision for any variable payments not recognized in the lease liability?

View A – No onerous provision should be recognized by Retailer A

Proponents of this view refer to paragraph BC72 of the Basis for Conclusions to IFRS 16 and note that IFRS 16 lacks guidance on onerous contracts. Furthermore, paragraph 5(c) of IAS 37 seems to

exclude leases from its scope unless they:

- become onerous before the commencement date of the lease; or
- are short-term leases or low-value leases in accordance with paragraph 6 of IFRS 16 and have become onerous.

Since the fact pattern described does not meet any of the factors described above, no onerous provision should be recognized for the variable payments. Therefore, these payments should be expensed as incurred over the remainder of the lease.

View B – An onerous lease provision should be recognized for the anticipated annual payments for the next three years

Proponents of this view note that paragraph 5 of IAS 37 states "When another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard" before listing more specific examples of provisions such as leases. This indicates that paragraph 5(c) of IAS 37 only scopes out those amounts that are included in the recognized lease liability on the balance sheet.

Since the variable payments are not recognized in the lease liability, these amounts should be in scope of IAS 37. Therefore, an onerous provision should be recognized by Retailer A for the anticipated annual payment of $7,000 for the next three years.

The Group's Discussion

Group members expressed diverse views on this issue.

Some Group members preferred View A. They emphasized the IASB's decision not to include requirements for onerous contracts in IFRS 16 as explained in paragraph BC72(a) of the Basis for Conclusions to IFRS 16. Also, these members noted that the fact pattern does not fit the criteria in paragraph 5(c) of IAS 37 and, therefore, IAS 37 should not apply. One Group member referred to paragraph BC169 of the Basis for Conclusions to IFRS 16 that highlights the reasons that the IASB decided to exclude variable lease payments linked to future performance or use of an underlying asset, from the measurement of lease liabilities. As such, this Group member supported View A to not record a provision.

One Group member commented that Retailer A's election to account for each lease component and non-lease component as a single lease component signals its decision to account for the entire lease payments under IFRS 16 rather than IAS 37. Therefore, since IFRS 16 does not recognize variable lease payments in the lease liability, they should be expensed when incurred. Another Group member noted that, from a practical perspective, companies may have a portfolio of retail properties with many variable lease payments, and that operationally it is easier to expense these variable lease payments as incurred.

Other Group members supported View B. They noted that paragraph 5(c) of IAS 37 only scopes out those amounts that are included in the recognized lease liability. Since the variable payments are not recognized as lease liabilities, the scope exception from IAS 37 should not apply. Furthermore, these Group members thought that because the ROU asset has been impaired to nil and the property has

been vacated, the unavoidable cost of realty taxes and maintenance costs exceed the economic benefit. In addition, they thought that the payments are probable of occurring and their amounts are reliably measurable. Therefore, an onerous lease provision should be recognized. Some Group members also considered the scenario of subleasing arrangements. They thought View A is inconsistent with including the variable lease payments in the cash flow forecast to determine the amount of impairment on the ROU asset.

Considering the diverse views expressed and that the use of variable payments in a lease arrangement is becoming more common in practice, Group members recommended that this issue be discussed with the AcSB to determine whether it should be raised to the IASB or the IFRS Interpretations Committee.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

IFRS 16, IAS 16, and IAS 23: Timing of Depreciation of a Right of Use Asset and IAS 23 Capitalization

Group members are asked to consider the interaction of IFRS 16 *Leases* and IAS 16 *Property, Plant and Equipment* when a right-of-use (ROU) asset is used to construct an item of property, plant, and equipment (PP&E). Specifically, Group members will discuss the timing of depreciation of the ROU asset and whether this depreciation could be capitalized to the asset under construction. Furthermore, Group members are asked to consider whether the interest expense related to the lease obligation can be capitalized as a borrowing cost during the construction period of a qualifying asset, in accordance with IAS 23 *Borrowing Costs*.

Fact Pattern

- Entity A enters into a contract for a ground lease of land and begins construction of a manufacturing facility where it will operate its manufacturing plant. The contract is determined to be a lease under IFRS 16. The lease commenced on September 1, 2019. On that same day, Entity A starts constructing a building on the land. Construction is expected to be completed after October 1, 2020. The lease consists of fixed rent payments with a term of 40 years. The lease contract has no other renewal, termination, or purchase options.

Issue 1: When does depreciation of the ROU asset commence?

View 1A – Depreciation of the ROU asset should start on the lease commencement date

Proponents of this view note paragraph 32 of IFRS 16 requires depreciation of the ROU asset from the commencement date of the lease. Furthermore, they note that the rights conveyed under a lease contain an explicit time element as a lease is a right to use an asset for a period of time in exchange for consideration. Therefore, depreciation of the ROU asset should start at the lease commencement date.

View 1B – Depreciation should start when the asset is in a condition necessary for its intended use

Supporters of this view note paragraph 55 of IAS 16 requires the depreciation of an asset to begin “when it is available for use, i.e., when it is in the location and condition necessary for it to be capable

of operating in the manner intended by management." Therefore, since the facility would not be available for use until substantially all construction activity is completed and the use of the land is linked to the use of the facility, the deprecation of the ROU asset should begin after the construction period.

View 1C – Accounting policy choice

Proponents of this view think that the standards are not clear and therefore in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, an appropriate accounting policy should be developed and applied consistently supporting either View 1A or View 1B.

The Group's Discussion

Group members supported View A.

Some Group members noted that paragraph 31 of IFRS 16 states that a lessee shall apply the depreciation requirements in IAS 16 in depreciating the ROU asset, subject to the requirement in paragraph 32. Paragraph 32 of IFRS 16 provides specific guidance to require depreciation of an ROU asset from the lease commencement date and that this paragraph should be applied instead of IAS 16. Some Group members commented that the right to access the land should be considered separately from the construction of the building. Because the access to the land is granted at the lease commencement date and the land is also in a condition to be capable of operating in the manner intended by management to construct a building, these Group members thought depreciation of the ROU asset should start on the lease commencement date.

Issue 2: Presuming View 1A is the appropriate view under Issue 1 and therefore depreciation of the ROU asset related to the land lease should begin at the lease commencement date, should depreciation on the ROU asset be capitalized to the asset under construction?

View 2A – Capitalize depreciation of the ROU asset into the cost of the manufacturing facility

Proponents of this view note that IAS 16 requires that PP&E be initially measured at cost. They argue that both paragraphs 10 and 16(b) of IAS 16 support the capitalization of depreciation of the ROU asset into the cost of the manufacturing facility.

The land under lease can be analogized to a leased asset that is used to construct an item of PP&E. Per paragraph 10 of IAS 16 states, "The cost of an item of property, plant and equipment may include costs incurred relating to leases of assets that are used to construct, add to, replace part of or service an item of property, plant and equipment, such as depreciation of right-of-use assets."

Furthermore, paragraph 16(b) of IAS 16 defines one element of the cost of PP&E as "any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management." Access and use of the land upon which the facility is to be built is required to bring the facility to the condition necessary for its intended use by management.

Therefore, the depreciation of the ROU asset should be included in the cost of the manufacturing

facility.

View 2B – Expense depreciation of the ROU asset

Proponents of this view argue that the objective of depreciating the ROU asset is to reflect the consumption of the benefits associated with that asset over the appropriate period, being the lease term. As the lessee realizes these benefits starting from the lease commencement date, it is appropriate to start expensing the depreciation of the ROU asset immediately from the commencement of the lease.

The Group's Discussion

Most Group members supported view 2A. These members considered the depreciation of the ROU asset as a cost that is directly attributable to bringing the building into the condition necessary for it to be capable of operating in the manner intended by management. Some Group members also analogized access to the land with use of construction equipment and noted that both are directly attributable to bring the building to its intended use. One Group member also noted that under superseded IAS 17 *Leases,* the operating lease payments would be capitalized to the cost of the building.

A few Group members preferred View 2B. They considered the benefit of the leased ROU asset is to have access to the land over time rather than constructing the building. One Group member noted that the land generally retains its value and if the land is owned, the cost of the land would not be capitalized into the building. Other Group members commented that the ROU asset is different from the underlying asset. In this fact pattern, the ROU is the access to the land and has a finite life that should be amortized.

Issue 3: Presuming the property under construction is a "qualifying asset" under IAS 23, should the interest on the lease liability be capitalized as a borrowing cost during the construction period?

Analysis

Paragraph 8 of IAS 23 requires an entity to capitalise borrowing cost that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. The definition of borrowing costs in paragraph 6(d) of IAS 23 include "interest in respect of lease liabilities recognized under IFRS 16." This supports the capitalization of interest on the lease liability as a borrowing cost.

Paragraph 17 of IAS 23 further states the commencement date for capitalization of borrowing costs to be the date when the entity first meets all three conditions:

- It incurs expenditures for the asset;
- It incurs the borrowing costs; and
- It undertakes activities that are necessary to prepare the asset for its intended use or sale.

In the fact pattern presented, all three conditions are met on the commencement date of the lease. Therefore, Entity A would capitalize the interest on the lease liability to the facility being constructed

from the lease commencement date to the date construction is substantially completed.

The Group's Discussion

Group members agreed with the analysis.

One Group member observed that capitalizing depreciation and borrowing costs over time would achieve similar results as capitalizing the lease expense under superseded IAS 17. Another Group member noted that the lease liability should be placed in the general borrowing pool used to calculate the capitalization rate. This is because the lease liability is related specifically to the ROU asset, not to the qualifying asset.

Overall, the Group members considered the guidance provided in the standards to be clear for the issues discussed. Therefore, no further action on these issues was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

IFRS 9 and IAS 39: IBOR Reform and Impacts on Financial Reporting

Interest rate benchmarks such as interbank offer rates (IBORs) are key to global financial system stability because they are used either directly or indirectly for a wide variety of financial products and contracts. Market developments have undermined the reliability of some existing benchmarks. In this context, the Financial Stability Board has published a report- "Reforming Major Interest Rate Benchmarks" setting out recommendations to reform such benchmarks. Following these recommendations, some jurisdictions have made progress toward replacing existing benchmarks with alternative benchmark rates. This work has led to uncertainty about the future of existing interest rate benchmarks, which may affect company's financial reporting.

The IASB has identified two groups of accounting issues that could have financial reporting implications from the reform. Phase I of the IBOR reform project addresses the issues affecting financial reporting in the period before the replacement of the existing interest rate benchmark. Phase II of the IBOR reform project address issues that might affect financial reporting when an existing interest rate benchmark is replaced with another benchmark.

The Group is asked to consider the current development of the IBOR reform and discuss potential Phase II financial reporting issues.

Observations on Phase I of the IBOR reform project

- In Phase I of the IBOR project, the IASB addressed the more urgent issues related to uncertainties arising from the IBOR reform on the hedge accounting requirements in IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*.
- The proposed amendments to IFRS 9 and IAS 39 allow entities to continue applying hedge accounting where the cash flows of particular instruments are impacted by the IBOR reform. The proposed amendments are expected to be effective for annual periods beginning on or after January 1, 2020 with early application permitted and with retrospective application.

- At its August 28, 2019 meeting, the IASB determined that it would amend the proposed disclosure required by IFRS 9 and IAS 39 to include:
  - a description of the significant interest rate benchmarks to which the entity's hedging relationships are exposed;
  - an explanation of how the entity is managing its transition to using an alternative interest rate benchmark;
  - an explanation of significant assumptions or judgments the entity made in applying the exceptions to those hedging relationships within the scope of the amendments; and
  - the nominal amount of the hedging instruments and the extent of risk exposure the entity manages that is affected by the reform.

Issue: Accounting issues to be addressed in Phase II of the IBOR reform project

The IASB considers the following issues important and expects to address them in Phase II of the project:

(a) Modification of financial assets or financial liabilities: there may be bilateral modifications to contracts so that both parties to the arrangement can agree on new contract terms. This may be necessary where debt or derivative contracts have ineffective fallback clauses or the parties in the arrangements wish to clarify how interest rates will be computed. Under IFRS 9, both modification and extinguishment of debt can lead to a charge or a credit to the income statement. The considerations on how to compute these amounts can be complex. The IASB will need to consider whether any relief will be granted to the contract modification vs extinguishment guidance as a result of the IBOR reform.

(b) Classification and impairment of financial instruments: the IASB should consider whether the changes to reset dates and compounding periods would cause financial assets to fail the solely payments of principal and interest on the principal outstanding (SPPI) assessment and whether modifications that result in derecognition impact the business model assessment. In addition, the IASB should consider the impact of derecognition from failure of current classification criteria on loan loss impairment models.

(c) Hedge accounting: the IASB needs to consider how existing hedging relationships will be affected as benchmark reform proceeds. This includes whether hedge documentation can be modified or amended and whether the existing hedging relationship will continue.

(d) Other issues: Other non-financial items may be affected, including interest indexed lease arrangements, discount rates for non-financial asset impairment tests, decommissioning and other provisions and fair value measurements (e.g. for investment properties).

Addressing these issues is likely to be made more complex because benchmark reform is proceeding on a different timeline in different jurisdictions and in different ways.

The Group's Discussion

Regarding Phase I of the IBOR reform project, the Group Chair noted that the IASB will publish the final amendments by the end of September 2019. Upon completion of the AcSB's due process, these amendments will be incorporated into Part I of the CPA Canada Handbook- Accounting by November 1, 2019.

Group members agreed with the Phase II issues identified above. Several Group members observed the operational complexities associated with the IBOR reform. One Group member commented that the terms of the debt agreement may not include fallback clauses or may include an ineffective fallback clause. Therefore, entities may need to clarify with their lenders when the fallback clauses are triggered, and the additional costs associated with triggering the clause. Another Group member noted that derivative agreements are often bilateral. Therefore, the terms of derivatives, which are based on IBOR, may also need to be changed. One Group member also commented that for investment entities, IBOR is often used as a benchmark to evaluate performance and that the performance measurement process can be affected when IBOR benchmark rates cease to exist.

The Group discussed whether using a replacement rate when IBOR is discontinued should be treated as a debt modification. One Group member thought that if a debt agreement includes clear and specific fallback clauses, triggering those clauses would not constitute a debt modification since they are pursuant to the terms of the agreement. Another Group member questioned whether potential relief granted to debt modification should include other terms in addition to the benchmark interest rate that might need to be revised as part of the IBOR reform. This Group member also observed that the Phase II issues are often inter-related. For example, the outcome from a debt modification assessment could cause a discontinuation of hedge accounting involving that debt.

One Group member considered the IBOR reform's impact on financial instrument valuation. This Group member commented that it can be challenging to categorize inputs as level 2 or 3 in accordance with IFRS 13 *Fair Value Measurement* as the new benchmark rates build their liquidity, and while IBOR benchmarks become illiquid. Another Group member noted that for financial liabilities measured at fair value, the IBOR reform could impact the measurement of entities' own credit risk, which is often expressed as a spread to a benchmark such as IBOR. This spread may need to be recalibrated to accommodate a change from IBOR to a new benchmark rate.

The Group then discussed broad financial reporting implications that the IBOR reform has on both financial and non-financial institutions. One Group member commented that major Canadian financial institutions have established project teams to implement process changes in response to the IBOR reform. This Group member observed that the effort spent on disclosing transition management, derivative valuation and risk exposure is significant, especially considering that the final amendment will be published close to the year-end. Some Group members commented that non-financial institutions often have loans, derivative instruments, and lease agreements that have IBOR components. They thought diversity in structuring fallback clauses can increase the complexity and effort for entities to assess the impacts of the IBOR reform.

The overall objective of this discussion is to raise awareness of Phase II of the IBOR reform project. Stakeholders are encouraged to stay informed on the development of this project. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

IFRS 3: Application Issues from an Asset Acquisition

The IASB amended IFRS 3 *Business Combinations* in October 2018 to clarify the definition of a business. The amendments did not change how a business combination is accounted for, rather, they clarify which transactions are accounted for as a business combination.

Included in the amendments is an optional concentration test. This test simplifies the assessment of whether an acquired set of activities and assets is a business. An entity can elect to use this test on a transaction-by-transaction basis or to all acquisitions. These amendments are effective for all transactions occurring on or after January 1, 2020, with earlier application permitted.

The Group will consider several practical matters arising from an entity's election to use the optional concentration test.

Issue 1: General observations on electing to apply the optional concentration test

Analysis

Assuming the concentration test is met, the transaction is an asset acquisition rather than a business combination. It will impact an entity's reported net assets and profits. Some of the more common impacts on an entity's reported results are summarized below:

	Asset Acquisition	**Business Combination**
General approach	Measure the assets acquired based on their cost, which is generally allocated on a relative fair value basis	Measure identifiable assets and liabilities at fair value
Transaction costs	Capitalized	Expensed
Goodwill	Not permitted	Recognized as an asset
Bargain purchase gain	Not permitted	Recognized in income
Deferred tax	Initial recognition exemption	Recognized as an asset/liability
Indemnification assets	IAS 37 applies	Specific guidance by exception
Contingent consideration to seller(s)	No guidance – can be complex	Recognized at fair value; remeasured through profit/loss if liability-settled
Measurement period	n/a	Cannot exceed 12 months from date of acquisition
Disclosures	Relatively LESS	Considerably MORE

Initially, entities may think that the optional concentration test will save time when determining whether the transaction should be accounted for as an asset acquisition or a business combination. However, this may not always be the case, given the level of effort still needed to apply the concentration test. Specifically, the concentration can be used if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. To apply this test, entities need to identify the various assets and liabilities acquired, including any intangible assets, and determine their fair value. Determining the fair value of various assets acquired can take time and often involves the use of specialists.

The Group's Discussion

Group members agreed with the analysis. They emphasized that although applying the concentration test is optional, once elected, the results from the concentration test must be applied. Some Group members noted that although the concentration test is a simplified approach to assess whether the transaction is an asset acquisition, the amount of effort required to perform the analysis, within a short period of time, can be significant. For example, some Group members commented that in a business combination, the acquirer may record provisional amounts for the assets acquired and liabilities assumed, and subsequently adjust these amounts during the measurement period. In contrast, the measurement period does not exist when determining the value of assets acquired or liabilities assumed in an asset acquisition. As such, the allocation of the purchase price needs to be finalized in time for the release of financial results. As a result, for an asset acquisition, any subsequent adjustments discovered post release of quarterly financial statements are likely to be considered as a correction of an error in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. A representative from the Canadian Securities Administrators noted the importance of the one-year measurement period to Canadian issuers subject to quarterly reporting requirements. This representative highlighted that subsequent adjustments to the value of assets and liabilities recognized in an asset acquisition may cause restatement of quarterly financial statements and could affect an entity's financial reporting in periods long past the initial acquisition.

Group members then commented on the practical benefits from applying the optional concentration test. Some Group members noted that in simple asset acquisitions, such as acquiring a company with only one license, applying the optional concentration test will allow the acquirer to quickly determine if the transaction is an asset acquisition. One Group member also thought that even though the concentration test may require work effort, an entity may prefer investing this time upfront, especially if the result of the assessment is that the transaction is an asset acquisition. This Group member highlighted several benefits of the transaction being accounted for as an asset acquisition including avoiding recognition of goodwill and its subsequent impairment testing, as well as business combination disclosure requirements, which can be burdensome.

Issue 2: How should an entity measure ordinary non-controlling interests (NCI) when less than 100 per cent of the equity interests in a legal entity are acquired?

Fact Pattern

- Parent acquires an 80 per cent interest in Subsidiary for $240 cash. Subsidiary's only assets are land and an unoccupied building. The transaction is accounted for as an asset acquisition. The following table includes other relevant information:

	Carrying Amount	Fair Value
Land	50	100
Building	150	200
FV of 20% of Subsidiary	–	50

View 2A –Ordinary NCI should be measured at fair value

Proponents of this view note that while there is no specific guidance in IFRS 3 on the cost of an asset acquisition, the cost of a transaction is generally measured at the fair value of the consideration transferred, similar to requirements in IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* or IAS 40 *Investment Property*. As NCI is allocated to the relative fair value of the assets acquired, the measurement of NCI should be consistent with other forms of consideration (i.e., fair value).

Additionally, proponents of this view note that when applying the concentration test, the gross assets acquired in the denominator of the test requires NCI to be recognized at fair value. Therefore, recognizing NCI at fair value would be consistent with the application of the concentration test.

Therefore, the parent entity should initially measure NCI in an asset acquisition at its fair value using IFRS 13 *Fair Value Measurement* in its consolidated financial statements.

View 2B – Ordinary NCI should be measured at the proportionate interest in the recognized amount of assets fair value

Proponents of this view note that IFRS 3 requires a cost-based approach for an asset acquisition. Therefore, measurement of NCI is driven by asset cost (i.e., 80 per cent of assets costs is $240, therefore NCI is $60 ($300−$240)).

Additionally, paragraph 2(b) of IFRS 3 does not permit the recognition of goodwill (or a bargain gain) in an asset acquisition. If ordinary NCI is measured at fair value, the fair value includes 'embedded goodwill or bargain gain' (fair value of NCI less fair value of NCIs share of identifiable assets). In the fact pattern provided there is an embedded bargain gain of $10 ($50−$60).Therefore, NCI is required to be measured based on the proportionate interest and must not be measured at fair value.

Furthermore, there is no requirement to be consistent with the application of the concentration test as this test does not dictate the recognition and measurement of assets in an asset acquisition.

Therefore, the parent entity should initially measure NCI in an asset acquisition at the proportionate interest in the recognized amount of the assets. Which in this case, NCI would be measured at $60 (20%×$300).

View 2C – Accounting policy choice on a transaction by transaction basis

Proponents of this view apply the IAS 8 hierarchy (specifically paragraph 11(a)) and analogize to IFRS 3 for a requirement in IFRS dealing with a similar and related issue. As IFRS 3 deals with initial measurement of NCI, an analogy to IFRS 3 is appropriate. Therefore, an entity can elect on a transaction-by-transaction basis to measure ordinary NCI at either fair value or the proportionate interest in the recognized amount of the identifiable net assets per paragraph 19 of IFRS 3.

In contrast to View 2D, proponents of View 2C note that the entire paragraph 19 of IFRS 3 should be applied by analogy, which includes allowing the policy choice for each asset acquisition.

View 2D – Accounting policy choice to be applied consistently

Proponents of this view also apply the IAS 8 hierarchy and analogize to IFRS 3. However, in contrast to View 2C an entity elects an accounting policy that is applied consistently to measure ordinary NCI in all asset acquisitions. This is because paragraph 13 of IAS 8 requires an accounting policy to be applied consistently to all similar items unless an IFRS specifically permits otherwise. Although the measurement of NCI at fair value or proportionate interest is based on an analogy to IFRS 3, the general principles of IAS 8 take precedence and therefore prohibit a transaction by transaction application.

The Group's Discussion

Group members acknowledged that both View 2A and View 2B have merit and supported an accounting policy choice. Group members expressed mixed views on View 2C and View 2D. Most Group members supported View 2D, highlighting the general principles of IAS 8 should take precedence. Therefore, paragraph 13 of IAS 8 requires an accounting policy to be applied consistently to all similar items. Some Group members supported View 2C, noting that paragraph 19 of IFRS 3 should be applied by analogy in its entirety, which includes allowing a policy choice for each asset acquisition.

Some Group members preferred View 2A. One Group member agreed with the analysis that recognizing NCI at fair value would be consistent with the application of the concentration test. Other Group members noted that although View 2A was the preferred approach, the fair value of the NCI can be challenging to determine in practice.

A few members preferred View 2B. One Group member thought that the concentration test is used to assess whether the transaction is an asset acquisition and that the test does not dictate the recognition and measurement of assets in an asset acquisition. In addition, this Group member considered the nature of NCI as being equity, as defined in IFRS 10 *Consolidated Financial Statements* and thought fair valuing NCI is inconsistent with the cost-based measurement of net assets that gave rise to the NCI.

Issue 3: How to account for the previously held interests in an asset acquisition?

- Entity P previously held a 20 per cent equity method investment in Entity S. P's current equity method carrying value of its investment in S is $40 and its fair value is $60. P acquires the remaining 80 per cent interest in S for $240. S's only assets are land and an unoccupied building as follows. The transaction is accounted for as an asset acquisition. Other relevant information includes:

	Carrying Amount	Fair Value
Land	50	100
Building	150	200

View 3A – Previously held interest should be remeasured to fair value

Proponents of this view analogize to IFRS 3 and remeasure the previously held interest to fair value on the date that control is obtained. Any gain or loss on the previously held interest is recognized in profit or loss.

In addition, they note that when applying the optional concentration test, the gross assets acquired in the denominator of the test requires previously held interests to be recognized at fair value. Therefore, recognizing the previously held interest at fair value would be consistent with the application of the concentration test.

View 3B – Previously held interest should be measured at its carrying amount

Proponents of this view refer to the January 2016 IFRS Interpretations Committee discussion on the remeasurement of previously held interests in a joint operation that is not a business. It was noted that IFRS 3 requires a cost-based approach for an asset acquisition and in a cost-based approach the existing assets are generally not remeasured. Therefore, measuring the previously held equity interest at its carrying amount is the approach that is most consistent with this principle and a better analogy than the one in View 3A.

Furthermore, there is no requirement to be consistent with the application of the optional concentration test as this test does not dictate the recognition and measurement of assets in an asset acquisition.

View 3C – Accounting policy choice to be applied consistently

Under this view, since there is no specific guidance in IFRS, and given more than one acceptable alternative, an accounting policy choice is available to be applied consistently to the measurement of previously held interests

The Group's Discussion

Similar to Issue 2, most Group members acknowledged that both View 3A and View 3B have merit and thought that an accounting policy choice is appropriate.

Some Group members preferred View 3A. One Group member thought that referring to the January 2016 IFRIC discussion is not appropriate since Entity P uses the equity method to account for the investment in Entity S, which is more similar to a joint venture than a joint operation. Therefore, the additional acquisition can be analogized to derecognizing an equity accounted investee in exchange for control and therefore the previously held interest should be remeasured to fair value.

Several Group members preferred View 3B. These Group members thought that the principle from the January 2016 IFRIC discussion can be applied. In addition, they noted that since the assets acquired are land and building, IAS 16 *Property, Plant and Equipment* can be used by analogy. Paragraph 16(a) of IAS 16 states that the cost of an item of property, plant and equipment comprises its purchase price. Therefore, measuring the previously held interest at its carrying amount is more appropriate.

The purpose of the discussion was to raise awareness on challenges in applying the optional concentration test and measurement of NCI. The Group members recognized the merits in the views

expressed in both Issue 2 and 3 and acknowledged that accounting policy choices are likely to be significant and should be disclosed. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

IFRS 2: Share-based Payments for an Asset Acquisition

An entity may acquire an asset or a group of assets that do not comprise a business by issuing multiple financial instruments. Careful analysis is required to determine whether these instruments are in scope of IFRS 2 *Share-based Payments.* This standard can impact how the instruments are classified and measured both on initial recognition and subsequent measurement.

The Group is asked to consider a scenario where a company issues multiple financial instruments in exchange for assets of another company that do not comprise a business and to discuss whether any of the financial instruments issued are in scope of IFRS 2. The Group is then asked to consider whether a contingent payment should be considered as part of the cost of the assets acquired.

Issue 1: Are the following instruments in scope of IFRS 2?

Fact Pattern

- Entity A issues multiple financial instruments to Entity B in exchange for a group of assets that do not comprise a business. The assets acquired are in scope of IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*. The consideration paid includes:
  - A future issuance of common shares of Entity A with the number of shares determined by reference to the performance of the assets acquired;
  - A convertible note, which is a plain vanilla convertible debt instrument where:
    - interest is at a fixed rate payable monthly;
    - the principal is payable in cash on maturity; and
    - the note is convertible at the option of Entity B into common shares of Entity A at a fixed price;
  - A future cash payment contingent on Entity A's share price exceeding a certain threshold within a specified period of time. The amount payable is fixed and if the threshold is not met then no amount is payable;
  - Share purchase warrants giving Entity B the right to purchase common shares of Entity A. The exercise price will be adjusted if Entity A issues common shares at a price that is lower than the initial exercise price on issuance;
  - A future cash payment based on a valuation of Entity A determined by an agreed upon formula. The formula is a multiple of Entity A's earnings before interest, tax, depreciation and amortization (EBITDA) over a specified period of time; and
  - A future issuance of common shares of Entity A. However, if Entity A does not complete an initial public offering (IPO) before the date that the shares become issuable, then Entity A is instead required to make a cash payment of a fixed amount.

Analysis

(a) Share issuance based on asset performance: **In scope of IFRS 2** as it comprises an issuance of equity instruments as consideration for goods.

(b) Convertible note: **In scope of IFRS 2**. Entity B has a choice to receive either cash for interest and principal payment or a fixed number of shares of Entity A. IFRS 2 applies to transactions where either the entity or the counterparty has a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments. While the cash payments may not be based on the price of equity instruments of Entity A, this would not prevent the instrument from being in scope of IFRS 2 per paragraph BC256 of the Basis for Conclusions to IFRS 2.

(c) Future cash payment contingent on Entity A's share price: **Not in scope of IFRS 2**. IFRS 2 indicates that for cash-settled share-based payment transactions to be in its scope the amount of cash or other assets transferred must be based on the price of the equity instruments of the entity. While the requirement to make an additional payment is determined using Entity A's share price, the amount of cash that may become payable is fixed and is not based on the price of the equity instruments of Entity A.

(d) Share Purchase Warrants- Exercise Price not Fixed: **In scope of IFRS 2**. IFRS 2 defines equity instruments as "(a) contract that evidences the residual interest in the assets of an entity after deducting all of its liabilities." Furthermore, the definition of equity-settled share-based payments specifically includes options. Therefore, since Entity A will not be required to pay cash to settle this instrument, the warrants would be considered an equity-settled share-based payment in scope of IFRS 2 and be accounted as equity.

(e) Cash payment based on EBITDA formula: **Not in scope of IFRS 2**. The definition of a cash-settled share-based payment in the scope of IFRS 2 requires that the cash payment made is based on the value of the equity instruments of the entity. In this case, the EBITDA multiplier will not necessarily determine the fair value of the equity instruments of Entity A and will not take into account other factors that might impact their fair value in the future (such as changes in interest and tax rates). Therefore, this does not result in the cash payment being based on the value of the equity instruments of Entity A.

(f) Future issuance of shares with cash alternative if no IPO: **Not in scope of IFRS 2**. This instrument does not satisfy the criteria to be classified as an equity-settled share-based payment as it may require settlement in cash. Furthermore, this instrument cannot be considered a cash-settled share-based payment as the amount that Entity A may be required to pay is fixed and therefore not based on the price of Entity A's equity instruments.

The Group's Discussion

Group members agreed with the analysis for instruments A, C-E and offered different views on instruments B and F.

For Instrument B (convertible notes), one Group member thought that this instrument could be in the scope of IFRS 9 *Financial Instruments* because the holder of the instrument has the option to collect interest on the convertible notes or to receive shares. Some Group members likened this instrument to a tandem option where the holder has the option to choose to receive either a fixed amount of cash or shares and thought they are in the scope of IFRS 2.

For Instrument F (future issuance of shares with cash alternative if no IPO), one Group member thought this instrument is in scope of IFRS 2 because the payment is shares. This Group member did not consider the cash settlement feature to be significant to justify excluding the instrument from IFRS 2 because it will only occur if there is no IPO. However, some other Group members offered a different view. They thought that the cash settlement feature is important because this feature protects the instrument holder if there is no IPO and gives the entity an option for cash payment if it decides to abandon an IPO. Therefore, they agreed with the analysis that the instrument is not in scope of IFRS 2 based on this cash settlement feature.

The Group also agreed that if the instrument is not in scope of IFRS 2, then it will be in scope of IFRS 9 which requires fair valuing the instrument at the inception of the contract.

Issue 2: Contingent consideration linked to the performance of an Entity's share price.

IFRS 3 *Business Combinations* is clear that contingent consideration payable in a business combination should be recognized at fair value as part of the consideration transferred. However, IFRSs do not contain explicit guidance on the accounting for contingent consideration if the assets acquired do not constitute a business as defined in IFRS 3.

In September 2014 and May 2016, the Group discussed the accounting for contingent consideration where Entity A acquires one or more assets that do not constitute a business. The May 2016 discussion considered whether there had been any changes in the Group's views as a result of the March 2016 IFRS Interpretations Committee (IFRS IC) agenda decision. In the final agenda decision, the IFRS IC stated that it could not reach a consensus on whether the variable payments that depend on the purchaser's future activity should be recognized as a liability on the purchase date of the asset or only when that activity is performed, nor did the IFRS IC reach a consensus about what the initial or subsequent measurement of this liability should be. The Group noted that preparers should carefully examine whether the facts and circumstances of an entity's situation are similar to the fact pattern the IFRS IC described.

This issue considers examples where the consideration is in scope of IFRS 2 and whether the contingent payment should be considered part of the cost of the assets acquired.

Fact Pattern

- Entity A acquires from Entity B a group of assets that do not comprise a business. The consideration Entity A paid is:
  (a) shares of Entity A issuable on the date when control of the assets is transferred;

  (b) a future cash payment in one year equal to the increase in value of the Entity A shares issued since the acquisition date; and

  (c) additional Entity A shares with the number of shares determined based on the performance of the assets acquired from Entity B.

- Entity B has no further obligations to Entity A (i.e., no performance or service conditions) once the control of the assets has been transferred.
- Entity A has determined that it is unable to estimate reliably the fair value of the assets received. Furthermore, all of the assets received are within scope of IAS 16 and IAS 38 (i.e., there are no unidentifiable assets received (or to be received)).

Analysis

Not withstanding the IFRIC Agenda decision in March 2016, in this fact pattern, the cost of the assets is comprised of the fair value of the consideration paid to acquire the assets at the time of their acquisition. Therefore, Entity A would measure the fair value of the shares issued, as well as the fair value of the contingent elements, in determining the cost of the assets at the time that control is transferred.

Where the fair value of the goods or services received cannot be estimated reliably, paragraph 16 of IFRS 2 requires equity-settled share-based payment transactions to be measured by reference to the fair value of the equity instruments granted at the measurement date (which in this case would be the date that the assets are transferred from Entity B to Entity A). Paragraph 30 of IFRS 2 requires, for cash-settled shared-based payment transactions, an entity to measure the goods or services acquired and the liability incurred at the fair value of the liability.

Because Entity B has no further performance or service conditions, both the additional cash payment based on the fair value of Entity A’s shares and the additional shares based on the performance of the assets acquired would be considered non-vesting conditions. Paragraphs 21A and 33C of IFRS 2 require that an entity shall take into account all non-vesting conditions when measuring the fair value of the equity instruments granted and cash-settled share payments granted, respectively.

No further adjustment is made to the fair value of the additional shares that may or may not be issued in accordance with paragraph 23 of IFRS 2.

Subsequent remeasurement of the liability for the additional cash payment is recognized in profit or loss in accordance with paragraph 30 of IFRS 2.

The Group's Discussion

Group members agreed with the analysis, emphasizing that equity-settled share-based payment transactions should be measured at the fair value of the goods or services received and that only in rare circumstances, where the fair value of the goods or services received cannot be estimated reliably, should the fair value of the equity instruments granted be used. Group Members also thought that it is important to perform a careful assessment to determine whether a transaction is in scope of IFRS 2. When the transaction is in the scope of IFRS 2, Group members agreed that all the elements in the share-based payments (including the contingent elements) are in the scope of IFRS 2 and should be measured using the fair value of goods or services received or provided when equity settled. Group members also thought that the contingent consideration might be accounted for differently if it is determined that the transaction is not in scope of IFRS 2.

The purpose of the discussion is to raise awareness on accounting for share-based payments for an asset acquisition, no further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

IAS 32 and IFRS 9: Allocating Transaction Price to Multiple Elements of a Transaction Involving Warrants

Entities often issue securities that consist of a standalone equity instrument (e.g. share purchase warrant or a share) and a debt instrument (e.g. a note or debenture) that have been contractually linked as a unit solely for the purpose of offering them for sale to investors. The investor subscribes and pays a fixed price for these units. Upon purchase, the two instruments in the unit can be separated and transferred independently.

The Group is asked to consider specific examples of the following two units and discuss the initial measurement of these units from the issuer's perspective:

(a) Unit A: one share and one warrant that both meet the IAS 32 *Financial Instruments: Presentation* criteria to be classified as equity instruments, and

(b) Unit B: one debenture and one warrant that meets the IAS 32 criteria to be classified as financial liabilities

Fact Pattern 1

- Entity A, a publicly traded company issues a unit consisting of one common share and one warrant. The purchaser pays CU 100 to purchase the unit. Assume there are no transaction costs.
- The common share is classified as an equity instrument as it satisfies the conditions in paragraph 16(a) of IAS 32. The warrant entitles the holder to purchase one common share of Entity A at a future date for a fixed amount of cash. Therefore, it satisfies the criteria to be

classified as an equity instrument in paragraph16(b)(ii) of IAS 32 (i.e., the "fixed for fixed" test is satisfied).

- Subsequent to issuance, the purchaser is free to trade the individual components of the unit (e.g. the common share and the warrant) separately.
- The sum of the individual fair values of the instruments are CU 105 at the time of purchase. Therefore, the transaction price is less than the total fair values of the financial instruments.

Issue 1: On what basis should the CU 100 of proceeds be allocated to the two components, which in this case, are both classified as equity instruments?

Regardless of the views expressed below, the total transaction price will be allocated to total equity. The implication of the allocation between the two instruments in the unit are the presentation between share capital and other components of equity, both at initial recognition and subsequent measurement.

View 1A – The transaction price should be allocated on a reasonable basis, such as proportionately based on the relative standalone fair values of the instruments

Proponents of this view think that since IFRS Standards do not provide guidance on how to split the total proceeds relating to a unit comprising two equity instruments, the entity can choose a relevant and reliable accounting policy in accordance with paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to allocate the proceeds to the two components. In reaching this conclusion, they note that guidance under IAS 32 relating to compound financial instruments are not applicable because the common share and the warrant are separate equity instruments rather than part of a compound instrument.

One appropriate method to allocate the total transaction price may be based on the relative standalone fair values. For example, the portion allocated to the warrant is the fair value of the warrant divided by the total fair value of both the share and warrant. The fair value of Entity A's common share would be readily obtainable as it is a publicly traded company. The fair value of the warrant could be calculated using option valuation techniques such as Black-Scholes model.

View 1B – The more reliably measured component should be measured first, with the residual amount being allocated to the second component.

Proponents of this view consider allocating the transaction price first to the more reliably measurable financial instrument to result in more useful information. Since the fair value of the common share would be readily obtainable, the common share should be recorded at its fair value. The remainder of the CU 100 transaction price is allocated to the warrant. Furthermore, they argue it would not be

appropriate to measure the common share at a different value than its fair value, which is readily obtainable price in the market.

View 1C – Separating the two components is not required

Proponents of this view note that while both components will be presented as equity, IAS 1 *Presentation of Financial Statements* does not require a separate presentation of common shares and warrants. Therefore, separating the two components is not required.

View 1D – Accounting policy choice

Proponents of this view think that the IFRS Standards are not clear and, therefore, there is an accounting policy choice.

The Group's Discussion

Most Group members supported both Views 1A and 1B. They observed that both views are being applied in practice and thought both views can be accepted so long as the method is applied consistently.

Some Group members preferred View 1B. They observed that in practice it can be burdensome for financial statement preparers and auditors to use complex models to value each component. View 1B is also more in line with paragraph 31 of IAS 32 that describes the measurement of equity and liability in a compound instrument.

Group members who supported View 1A observed that in practice the residual amount allocated to the warrant can be zero under View 1B. However, they did not think a zero value reflects the fair value of the warrant.

Group members did not find 1C to be appropriate. They thought warrants and common shares are different and should be presented separately.

Fact Pattern 2

- Entity B is a publicly traded company. It issues a unit consisting of one debenture and one warrant. The purchaser pays CU 100 to purchase the unit. Assume that there are no transaction costs.
- The debenture is classified as a financial liability as it is unconditionally due in three years, with principal and accrued interest payable on maturity. It will subsequently be measured at amortized cost, because none of the conditions as outlined in paragraphs 4.2.1 (a)-(e) of IFRS 9 *Financial Instruments* apply.
- The warrant entitles the holder to purchase one common share of Entity B at a future date for a fixed amount of cash. However, the exercise price of the warrant is in a currency other than Entity B's functional currency. As such, the warrant does not satisfy the conditions in paragraph

16(b)(ii) of IAS 32 to be classified as an equity instrument (i.e., the “fixed for fixed” test is not satisfied). Therefore, the warrant is classified as a derivative financial instrument.

- Subsequent to issuance, the purchaser is free to trade the individual components of the unit (e.g. the debenture and the warrant) separately.
- The sum of the individual fair values of the instruments are CU105 at the time of purchase, therefore, the transaction price is less than the total fair values of the financial instruments.

Issue 2: On what basis should the CU 100 of proceeds be allocated to the two components, which in this case, are both classified as financial liabilities?

Regardless of the view expressed, the total transaction price will be allocated to financial liabilities. The implication of the allocation between the two elements in the unit is the presentation between the debenture and the warrant on initial recognition and subsequent measurement. Per IFRS 9, the debenture is likely to be accounted for at amortized cost whereas the warrant is accounted for at fair value through profit or loss. Therefore, the initial value allocated to each component will affect subsequent measurement.

View 2A – The transaction price should be allocated on a reasonable basis, such as proportionately based on the relative standalone fair value of the instruments

Similar to View 1A, proponents of this view think that since IFRS Standards do not provide guidance on how to split the total proceeds relating to a unit comprising two liability instruments, the entity can choose a relevant and reliable method such as allocating the total transaction price based on the relative standalone fair value.

Because the sum of the individual fair values of the debenture and the warrant is higher than the transaction price for the unit, and this difference is not related to level 1 inputs (or where the FV of the item is not based on a valuation technique that uses only data from observable markets) in the fair value hierarchy described in paragraphs 76 to 80 of IFRS 13 *Fair Value Measurement*, paragraph B5.1.2A(b) of IFRS 9 requires this difference to be deferred. The subsequent fair value of the warrant will be “calibrated” to account for this initially deferred difference. This results in the warrant not being carried at its fair value either at the initial recognition or subsequently.

The debenture is subsequently accounted for at amortized cost. Therefore, the difference between the fair value and the allocated transaction price would “unwind” based on the guidance in paragraph B5.1.2A(b) of IFRS 9.

View 2B – The transaction price should be allocated on a reasonable basis, with the most reasonable basis being to allocate the transaction price to the derivative instrument first.

Consistent with View 2A, a difference between the fair value of the instruments and the transaction price exists. This difference still needs to be allocated between the debenture and the warrant. However, under this view, some think that the more reasonable basis for allocation is to allocate the transaction price first to the warrant, with any remainder to the debenture.

By allocating the transaction price first to the warrant, no “calibration” as noted in View 2A is required since the warrant would be initially measured at its fair value.

View 2C – Measure the derivative liability at its fair value first, and allocate the residual transaction price to the debenture (apply the embedded derivative guidance by analogy).

While this unit does not contain embedded derivatives, proponents of this view argue applying embedded derivative measurement guidance in paragraph B4.3.3 of IFRS 9 may produce the most useful information to the users of financial statements. This is because the unit acts in substance like an instrument with an embedded derivative: the unit is priced identically to a single host instrument with an embedded derivative mimicking the features of a warrant.

Paragraph B4.3.3 of IFRS 9 states that the initial carrying value of a host instrument is the residual amount after separating the embedded derivative. The result of this view is the same as View 2B, however, it is achieved by applying different IFRS guidance.

View 2D – Accounting policy choice.

Proponents of this view would argue that the standards are not clear and, therefore, there is an accounting policy choice.

The Group's Discussion

Based on the fact pattern given, most Group members support view 2A. Some Group members noted that it is uncommon in practice to have the sum of individual fair values of the debenture and warrants to exceed the transaction price (resulting in a "day 1" difference). Members encourage a careful review of the assumptions and unobservable inputs used to calculate the fair value of the components to the instrument to understand the cause of the difference.

Some Group members observed that View 2C is being applied in practice. One Group member commented that this approach is being used to avoid assigning a value to a warrant that is different from its fair value, which could result in a gain or loss subsequent to initial recognition.

The purpose of the discussion is to raise awareness on different approaches to allocate transaction price to a transaction involving warrants. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip.)

UPDATE ON PREVIOUS ITEMS DISCUSSED BY THE GROUP

IAS 41: Cannabis Accounting – Costs Incurred Related to Biological Transformation and Presentation

At the January 2019 meeting, the AcSB staff reported that the AcSB submitted this issue to the IFRS Interpretations Committee for consideration.

At its September 2019 meeting, the Committee finalized the agenda decision. The Committee decided not to add the matter to its standard setting agenda since it has not obtained evidence to suggest that standard-setting on this matter at this time would result in an improvement to the financial reporting that would sufficiently outweigh the costs. The agenda decision concludes that when applying IAS 41 *Agriculture*, an entity either capitalizes subsequent expenditure or recognizes it as an expense as incurred.

The agenda decision also highlights presentation and disclosure requirements in IAS 1 *Presentation*

of Financial Statements that entities should apply to help financial statement users understand how subsequent expenditures are reflected in reported financial performance.

IFRS 16: Right to Control Assessment

At the June 2019 meeting, the Group recommended the AcSB to consider referring the issue on rights of first refusal to the remaining capacity of a pipeline in assessing right to control under IFRS 16 *Leases* to the IASB or the IFRS Interpretations Committee. The AcSB discussed the Group's recommendation and has directed its staff to undertake further research to understand how pervasive the issue is across different industries in Canada.

The AcSB's staff has conducted a targeted outreach to Group members and will report back to the AcSB at a future meeting to discuss the outcome from the outreach.

IFRS 3, IAS 12, IFRIC 23: Uncertain Tax Position Acquired in a Business Combination

At the June 2019 meeting, the Group recommended the AcSB to consider referring the issue of whether the exception described in paragraph 24 of IFRS 3 *Business Combinations* could be revised to include both current and deferred tax assets or liabilities to the IASB or the IFRS Interpretations Committee. At its July and September meetings, the AcSB discussed the Group's recommendation and has directed staff to connect with the IASB staff to determine the most efficient and effective way to provide clarification on this issue.

OTHER MATTERS

Reminders on IASB® Documents for Comments

In July and August 2019, the IASB issued two standards-related exposure drafts:

- Deferred Taxes Related to Assets and Liabilities arising from a Single Transaction – comments are due November 14, 2019. The proposed amendments to IAS 12 *Income Taxes* requires an entity to recognize deferred tax on initial recognition of transactions to the extent that the transaction gives rise to equal amounts of deferred tax assets and liabilities. The proposed amendments would apply to particular transactions for which an entity recognizes both an asset and a liability (such as leases and decommissioning obligations).

- Disclosure of Accounting Policies – comments are due November 29, 2019. The proposed amendments to IAS 1 *Presentation of Financial Statements* and IFRS Practice Statement 2 *Making Materiality Judgements* are intended to help entities identify and disclose all accounting policies that provide material information to primary users of financial statements and identify immaterial accounting policies and eliminate them from their financial statements.

Stakeholders are encouraged to submit their comments to IASB, and also to the AcSB's corresponding Exposure Draft, by the comment period deadline.

(For opening remarks and updates, including other matters, listen to the audio clip.)

PRIVATE SESSION

The Group's mandate includes assisting the AcSB in influencing the development of IFRS Standards (e.g., providing advice on potential changes to IFRS Standards). The Group's discussion of these matters supports the AcSB in undertaking various activities to ensure the Canadian perspectives are considered internationally. Since these discussions do not relate to assisting stakeholders in applying issued IFRS Standards, this portion of the Group's meeting is generally conducted in private (consistent with the AcSB's other advisory committees).

IASB and IFRS Interpretations Committee – Documents for Comments

At its September 2019 meeting, the Group provided input on the following documents to assist in the development of the AcSB's response letters:

- IASB Exposure Draft, "Deferred Tax related to Assets and Liabilities arising from a Single Transaction (IAS 12)"; and
- IASB Exposure Draft, "Disclosures of Accounting Policies (IAS 1 and IFRS Practice Statement 2)".